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RESERVE ASSETS AND A SUBSTITUTION ACCOUNT

Towards a Less Unstable International Monetary System

by

The Reserve Assets Study Group of the Group of Thirty

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In a growing world economy, where economic and financial strength is more and more widely shared, the monetary system, based almost exclusively on one currency, the dollar, must naturally come under increasing strains. These strains, which will be aggravated by the continuing large payments surplus of OPEC countries now in prospect, have recently shown themselves in a tendency of many central banks around the world to 'diversify' the composition of their reserves. A so-called 'multi-currency reserve system' is developing.

Differing views may be held about the response (if any) that the international community should make to these developments. I and my colleagues in the Group of Thirty are of the opinion that if the process were left entirely to the interplay of market forces and the uncoordinated policies of individual central banks, the road ahead would indeed be a bumpy one for the world economy. A multiple currency reserve system is inherently unstable. Shifts in currency preferences of central banks would be an additional destabilizing element in foreign exchange markets. They would thus tend to increase fluctuations in exchange rates. Given the risks that these fluctuations would entail for trade, investment and employment, we believe that a cooperative approach to the problem is urgently required.

That is why we have chosen the subject "Reserve Assets and a Substitution Account" for the first of the policy statements which we plan to issue from time to time. The report that follows outlines some suggestions on how the world's financial community might respond to

the challenge. In the first place, it gives strong support to the proposal, on which important official discussions are being held, for the establishment of a Substitution Account in the International Monetary Fund. In addition, it suggests the development—as a complement to the Substitution Account—of forms of cooperation between central banks which would guide their policies to a less destabilizing pattern.

None of these suggestions will solve all the problems of the monetary system. There is no panacea. But they would help. They would at least take away some additional elements of instability and would move monetary arrangements in the direction of the aims which the international community has set for itself in the amended Articles of Agreement of the I.M.F.

The report has been drafted by the Reserve Assets Study Group of the Group of Thirty, and discussed by the full Group; these discussions were in turn taken into account in the final report. Nevertheless, many members of the Group of Thirty hold official positions and cannot for obvious reasons be held responsible for all the views expressed in the report. Members of the Group of Thirty participate in its meetings in a personal capacity and our reports and policy recommendations should not in any respect be taken to represent the views of institutions with which members are associated.

H. Johannes Witteveen
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Towards a Less Unstable International Monetary System

It is clear, in the opinion of the Study Group, that there is a serious reserve asset problem in today's international monetary arrangements. In particular, it is unlikely that the dollar can continue indefinitely to provide some 80 percent of the world's foreign exchange reserves. It may be felt that it is inappropriate for any national currency to play this central role and that efforts should be made over the longer term to establish the primacy of an international reserve asset; or it may be felt that there is a disequilibrium in the existing pattern of reserve holdings which can only be satisfied over time with the growth of other national currencies as reserve assets; or, even if neither of these long-run aims is subscribed to, it may be felt that the present situation leads to avoidable instability in foreign exchange markets.

This report sets out the conclusions of the Study Group of the Group of Thirty which has been considering these questions over the past few months. Members both of the Study Group and of the Group of Thirty participate in their meetings in a personal capacity and the present report should not be construed as reflecting the views of the institutions with which members are associated.

The report is divided into the following sections:

(a) The trend towards diversification of currency reserves;

(b) An SDR Substitution Account;

(c) The role of the private sector;

(d) Possible supplementary or alternative arrangements;

(e) Conclusion.

The Trend Towards Diversification

Aggregate estimates suggest that since 1970 central banks have moved out of sterling and into Deutschemarks and other non-dollar currencies but that there has been no net diversification out of the dollar, since the proportion of dollar holdings in total currency reserves has remained remarkably stable, at around 80 percent. However, the country composition of reserves shows that a number of groups of countries have reduced the proportion of dollars in their reserves, with some showing reductions in the absolute levels of their dollar holdings. If the five "reserve currency" countries (defined to include France, Germany, Japan, Switzerland and the United Kingdom) are excluded, the dollar proportion of the foreign exchange reserves of the remaining 76 countries covered in estimates prepared for the Group fell from 71.7 percent at December, 1970 to 67.0 percent at September, 1978. The increase in the dollar proportion of the "reserve currency" countries (from 91.3 percent to 93.3 percent over the same period) probably stemmed less from deliberate attempts to increase the total, or change the composition, of their reserves, than from active intervention in foreign exchange markets designed to affect their exchange rates. The dollar proportion of the reserves of several developing countries has fallen sharply. In addition, there is evidence that diversification by certain groups of countries assumed significant proportions towards the latter part of the period. Finally, official or quasi-official institutions other than central banks in some countries may have diversified on a larger scale than is suggested by the figures, which are based on holdings of central banks.

The weakness of the U.S. balance of payments has been one important factor in this trend towards diversification. Anticipations of a fall in the value of the dollar naturally create an incentive to diversify into other currencies, as do expectations of continued volatility in exchange rate movements. However, it is unlikely that an improvement in the U.S. balance of payments, as has occurred over the past year, can be expected to bring about a complete and sustained reversal of the process. Many factors other than the state of the U.S. current account or the outlook for the dollar are likely to influence portfolio decisions by central bankers. These include not only the changing composition of world trade but also the increasing sophistication of the foreign exchange management of many central banks, particularly in the developing world; the desire to purchase foreign currency assets matching the expected pattern of foreign currency expenditures on large-scale projects, again particularly in the developing world; the comparable desire to purchase assets to match interest and principal payments on international

borrowing, such as borrowing in the Eurobond or Eurocredit markets, denominated in non-dollar currencies; and the disappearance of the remaining inhibitions against using the Eurocurrency markets as means of diversifying into the currencies of those countries which do not wish to encourage the reserve-currency role of their national currencies.

Exchange rates may be influenced as much by anticipated as by actual diversification. While it may be questioned how far, if at all, the existing proportion of dollar holdings represents in aggregate "involuntary" accumulations, there can be little doubt that some large dollar holders have felt "locked in" in the sense that they believed dollar sales would adversely affect the values of their portfolios, i.e. their dollar holdings are believed to be too large for risk diversification. The desire for reserve diversification by some "reserve currency" central banks, which have in total increased the dollar proportion of their reserves, may also be significantly greater than the figures suggest, for reasons noted above.

The actual or potentially destabilizing effects of currency diversification are increased if, as is probable, central banks attempt (or are believed in the markets to desire) to change their portfolio mix at the margin at times of pressure on the dollar. In particular, such attempts, or market expectations of such attempts, may precipitate much larger private sales of the principal reserve currency, as was experienced at times during sterling's decline as a reserve currency. Expectations of both official and private sales may in turn trigger violent exchange-rate movements affecting the whole structure of the world's currency and trading arrangements.

The Study Group concluded that the pressures making for a greater degree of currency diversification by official and private holders were likely to persist; and that a system which relied on one national currency for the bulk of its currency reserves was likely, for that reason as well as others, to continue to experience large-scale, unpredictable and often destabilizing capital flows. At the same time, the internationalization of the banking systems of many countries, and in particular the gradual opening-up of the financial markets of some potential reserve-currency centers, would not only facilitate the emergence of currencies other than the dollar as reserve currencies but also in our view further increase the potentiality, unless accompanying measures were taken (see below), of such unpredictable large-scale capital flows. These flows would, however, be even less subject to control if holdings of non-dollar currencies continue to be diverted, as hitherto, largely to the Eurocurrency markets.

Although it is widely accepted that there is some unfulfilled desire on the part of official holders throughout the world to diversify somewhat out of dollars and into other currencies, a consensus has not yet developed as to the most appropriate means of meeting this demand. What is clear is that both existing and potential reserve centers are reluctant to promote the development of a multicurrency reserve system (MRS). This is understandable. First, both **a priori** analysis and the evidence from situations where bimetallism has prevailed in the past indicate the potential instability of any system based on more than one reserve asset. Secondly, the post-war years have highlighted the difficulties that can beset a mature reserve currency center if its performance is considered unsatisfactory. Thirdly, the exposure of a reserve center to large and sometimes sudden changes in the volume of externally-held short-term claims upon it can greatly complicate the operation of its domestic monetary policy. Fourthly, a decision to establish and operate new reserve currencies would be likely, unless very carefully handled, to have destabilizing effects on existing reserve currency centers and on major exchange rate relationships.

In the light of such considerations, and especially the intrinsic difficulty of managing a multi-currency system, the Group concluded that a major effort should be made to reach international agreement on a Substitution Account issuing claims denominated in SDRs.* The need to establish a Substitution Account is lent added urgency by the prospect that OPEC countries are likely to run a substantial aggregate current account surplus for a number of years. At the same time, recognizing that the trends towards currency diversification noted above are likely to continue over the next few years, the Group also considered possible ways in which the official international community might handle such pressures so as to minimize any disturbance or disruption they might cause while an SDR Substitution Account was being established and developed.

An SDR Substitution Account

A Substitution Account should serve the objectives both of promoting the use of the SDR as a reserve asset and of offering an alternative to the further diversification of currency reserves. A successful Substitution Account would therefore contribute to exchange rate stability, while in the long term it would also facilitate an orderly reduc-

*SDRs (Special Drawing Rights) are reserve assets issued by the International Monetary Fund. Their value in terms of the U.S. dollar is determined as the sum of the dollar values, based on market exchange rates, of specified quantities of 16 currencies.

tion in the reserve currency role of the dollar. An additional objective has occasionally been mentioned in this context—that of preventing renewed accumulations of dollars in national reserves. According to this view, agreement on the creation of a Substitution Account should be accompanied by an agreement to restrict further official accumulations of dollars. This would constitute, however, a large step towards what is referred to as "mandatory asset settlement" and would be impractical at the present time. It is, of course, possible that in the long run the international community may show itself prepared to make the important moves to an SDR-standard and a wider role for the SDR in official intervention in the foreign exchange market. The latter possibility points, in turn, even at this stage towards the desirability of promoting the use of the SDR and of SDR-denominated claims in the private market. However, the Group regards the role of an SDR Substitution Account at the present time as being essentially complementary to the range of existing reserve assets and to other steps that should be taken to improve the functioning of the system.

The basic framework of a Substitution Account might be as follows: participants would deposit foreign exchange (initially dollars) in an Account administered by the IMF, in return for SDR-denominated claims or 'certificates'; the managers of the Account would invest the funds in securities or other assets denominated in dollars; the Account would pay interest on the SDR claims and various arrangements would be made to ensure the full usability of the claims as reserve assets. There are, however, numerous questions and problems that have to be resolved in setting up an Account and we return to some of these below.

There are certain general principles and considerations that in the view of the Group should be followed for the scheme to make a worthwhile contribution:

(i) Participation should be voluntary.

(ii) Wide participation is essential.

(iii) The size of the Account should be significant in relation to existing foreign exchange holdings in the form of dollars. These totalled some SDR 150 billion as of June, 1979, but a sizable proportion is unlikely to be subject to diversification pressure; thus an account that amounted after a time to some SDR 50 billion would make an important contribution.

(iv) The scheme should be market-oriented, providing incentives for private-sector institutions to hold, and develop markets in, SDR-denominated claims.

(v) For all these reasons, the claims or certificates to be issued by the Account should be sufficiently attractive.

(It should be noted that substitution, which would not change the stock of reserves, should not be regarded as an alternative to the creation of SDRs by allocation).

The most important determinants of the attractiveness of the proposed SDR claim on the Substitution Account will be its yield and liquidity characteristics:

(i) Interest on the claims should be paid at a rate closely related to a weighted average of short-term rates prevailing in the major financial markets. It should be adjusted regularly, for example every three months. This aspect of our proposal is discussed further in the following section.

(ii) Interest could be paid either in dollars or in the form of additional SDR claims; one advantage of the latter method would be that the size of the Account would grow naturally over time.

(iii) Claims should be freely transferable between official participants, by mutual agreement.

(iv) Claims should also be freely transferable between official and private holders. This would enhance the liquidity of these claims, encourage their use by the private sector, and open the way to the eventual private use of SDRs proper (which cannot be held privately at present). However, private holders of dollars should not be permitted, at least initially, to deposit them with the Account, as this would unduly complicate its administration.

(v) We hope that over time a main way in which countries could obtain liquidity for their claims would be through the market; and if, as is suggested in (i) above, interest were paid at a market-related rate, the claims could be traded in a secondary market at or close to par. Initially, however, there would be a need for some official mechanism on which participants could rely, for selling their SDR claims in exchange for currencies, in

case of balance-of-payments need; i.e. use of acceptance/designation rules such as those employed to transfer SDRs proper and, beyond this, if necessary, encashment of the claims at par at the Account (i.e. participants would receive the dollar equivalent of the face-value of the SDR claim, at the $-SDR rate prevailing on the day of the transaction). The United States, though not a depositor, could also have an acceptance obligation; this would further enhance the liquidity of the scheme. We would hope that the need for, and the role of, this kind of mechanism would rapidly decline as the private market in SDR claims developed.

(vi) The SDR claim should be of indefinite maturity because substitution should be regarded as permanent.

It is the opinion of the Group that an Account issuing a claim having these characteristics would attract wide participation. Central banks would then gradually become accustomed to holding and using the SDR claim as the internationally respectable reserve asset.

To bring the Account into being, a reasonably large number of IMF member countries would agree to participate for a sufficiently large aggregate amount. Participation by developing countries with appreciable reserves as well as by industrial countries is essential. Subsequently, additional deposits could be made on specific dates both by original and new participants. The dollars deposited would be valued in SDRs on the basis of the $-SDR rate on the day of deposit.

As has been found in market attempts to develop a composite currency unit, such as the SDR, the fundamental problem is that of reaching a combination of interest yield and exchange risk that renders instruments denominated in such units acceptable both to borrowers and to lenders. In the context of the Substitution Account proposal, this problem presents itself in two forms:

First, what arrangements can be made to ensure that the income of the Account will be large enough to cover its interest payments to participants? Second, in the event of liquidation, how would the Account's obligations be settled?

(i) **Interest payments and receipts:**
As already noted, the SDR claim should bear interest at a rate closely related to market rates in the major financial centers.

The rate should be as high as is required to avoid the SDR claim being traded at a significant discount in secondary markets. The precise relationship of the SDR interest rate to other interest rates can only be discovered by experimentation and will certainly change over time, as the markets in these claims develop. We believe the managers of the Account should have discretion to vary the relationship of the rate to market rates from time to time, as they gain experience with private trading in the claim with the objective of avoiding a discount in the market.

How may the Account finance these interest payments? This raises the issues of the investment of the Account's assets and of possible ways of making good an emerging deficiency on interest account if necessary. On the first question, the Account could earn interest on its investments, which would naturally be in dollars, at the US long-term bond rate, and, as long-term rates have on average been higher than short-term rates in the past, it might be expected that this would be sufficient to cover interest payments on its SDR obligations. However, since the interest rate on the SDR claim would be adjusted every three months or so, and short-term rates may from time to time rise above long-term rates, we believe that the managers of the Account should be given a considerable degree of discretion in the conduct of their investment policy. For instance, a case could be made for allowing the managers some discretion to invest also in short-term claims, such as certificates of deposit issued by major banks. Funds might even be placed in the Euromarkets, if there were evidence that funds were being withdrawn on a large scale from the markets as a result of the establishment of the Substitution Account. The difficulty that might otherwise be created for borrowers is this market might be met in this way. This discretion for the managers of the Account would ensure that the interest earnings of the Account were related as closely as possible to its payments on its SDR obligations. At the same time, there would need to be firm safeguards to assure the United States and other countries that such investment would not cause additional complications for the conduct of their financial policies.

However, these approaches would not guarantee that the Account's interest earnings were sufficient in any given year to finance interest payments on SDR claims, given the possibility